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TAGS: EPET ENRG EINV PREL SA
SUBJECT: CONCERNS MOUNT REGARDING THE SAUDI GAS INDUSTRY

Classified By: Consul General John Kincannon for reasons 1.4 (b) and (d
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¶1. (SBU) SUMMARY: The early 2008 pullout of French energy giant Total from its Empty Quarter joint venture with Saudi Aramco and Royal Dutch Shell and the continued lack of success by Chinese, Russian, and Italian-Spanish JVs in efforts to discover commercially viable quantities of gas in the Empty Quarter have created increasing concern about the health of Saudi Arabia's gas sector. Exacerbating these concerns about less gas coming on-line than previously anticipated are problems related to rising project costs and scarce construction and skilled labor capacity. These structural business issues are inhibiting the energy industry throughout the Gulf region, and have already led to significant delays in Aramco projects. The rising costs of development become particularly problematic due to the low price - 75 cents per million British thermal units (Btu) - that Saudi Arabia, per upstream agreements, pays foreign companies for gas. Meanwhile, analyst forecasts create further anxiety indicating that due to Saudi Arabia's growing power generation needs and hopes to rapidly expand the petrochemical industry, by 2030 the country will require 14.5 billion cubic feet a day (cf/d) of natural gas, almost three times the 5.5 billion cf/d currently consumed. END SUMMARY.

EMPTY QUARTER: TRUE TO ITS NAME?

¶2. (SBU) The discovery and development of large amounts of non-associated gas in the Empty Quarter is a key component in Saudi Arabia's vision of a rapidly growing industrial sector led by a burgeoning petrochemical industry. For the first time since energy industry nationalization in the 1970s, Saudi Arabia included private foreign firms in upstream operations, creating four joint ventures (JVs) in 2003/2004 in an effort to achieve this goal. Royal Dutch Shell (40 percent), Total (30) and Aramco (30) formed the South Rub al-Khali (SRAK) JV. The other three partnerships - each consisting of a 20 percent Aramco and 80 percent international partner stake - are with Russia's Lukoil, China's Sinopec, and Italy's Eni working with the Spanish company Repsol YPF. With profit margins slim and the Rub al-Khali a severe environment, many observers believed that Saudi Aramco's JV partners saw the Empty Quarter projects as more important for a foot in the Saudi door than as significantly profitable business endeavors. According to an April 11, 2008 "Middle East Economic Digest" (MEED) article, the Ministry of Petroleum initially forecasted the consortiums could collectively produce up to two billion cubic feet a day (cf/d) of gas by 2011. Although American firms considered participating in these JVs, all withdrew from negotiations believing that the terms were unprofitable and the odds of success limited.

¶3. (U) More than four years after creating these joint ventures, all four have failed to find gas in commercial quantities, despite drilling at least ten wells between them. Fearing the worst, Total announced in February that it was

withdrawing from the SRAK project. In a February 7 "International Oil Daily" article, an industry source reported that Total made the decision based on a contract stipulation that allowed for withdrawal after the drilling of three dry wells. SRAK continues as 50/50 venture between Royal Dutch Shell and Aramco, the partnership announcing in February that it will continue with a new year-long seismic program. With the three previous dry wells having been in Area 1, located near the Yemeni border, the fourth well is being drilled in SRAK's Area 2, near the UAE border.

¶4. (C) In a sign that the government is committed to calming fears sparked by the Total departure, the Ministry of Petroleum granted an 18-month extension to the SRAK concession, originally slated to expire in January of 2009. Having blamed the delays on human resource concerns created by internal security problems from 2003 to 2005, the newly extended timeline will allow SRAK to drill seven wells, as originally planned (NOTE: Both Sino Saudi Gas and EniRepSa are reported to have applied for extensions, but have yet to receive approvals. END NOTE). Meanwhile, Eni CEO Paolo Scaroni told Dow Jones on April 20, 2007 that his company had "no plan to exit Saudi Arabia." Despite this Ministry extension and Eni show of support, however, the departure of the large and respected French energy major spurs local whispers that the Empty Quarter is without gas. This is an idea supported by former Aramco Senior Vice President Sadad al-Husseini, who in a June 3 meeting with PolOff said that Aramco knew decades ago that there was unlikely to be any commercially viable finds in the Empty Quarter. Based on research and exploration undertaken prior to the JVs, al-Husseini claims that the Empty Quarter had already been

marginalized in internal Aramco circles.

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COSTS RISE, AVAILABILITY OF CONTRACTORS AND LABOR FALLS
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¶5. (U) Adding to the pain of no commercial gas discoveries is the rise of costs associated with drilling each well. According to a March 25 article in The Wall Street Journal, industry observers report that while each well had been projected at costs of 30 million to 50 million USD in initial budgets, current costs are closer to 70 million USD per well. In addition to the regional crises of inflation and price hikes caused by the overbooking of major contracting firms, the physical environs of the Empty Quarter create particular problems. For example, SRAK had to build its own desert airstrip and bring in drinking water from the nearest town, approximately 190 miles away. The complex geology of the Empty Quarter - high temperatures and pressure levels, dangerous levels of hydrogen sulfide gas - has also made drilling a slower and thus more expensive proposition.

¶6. (U) Though the Gulf region is booming, year-over-year numbers in the awarding of oil and gas contracts show startling capacity limitations. From April 1, 2005 to March 31, 2006, MEED Projects reports that the value of engineering, procurement and construction (EPC) contracts awarded in the hydrocarbons sector of the GCC, Iran and Iraq was approximately 35 billion USD. Over this same period in 2006/2007, the total was 45 billion USD. In 2007/2008, this number fell to just over 15 billion USD. Despite the fact that the value of major projects in the Gulf reached the two trillion USD mark in March 2007, 75 percent of the announced projects in the region are yet to begin. The rising cost of personnel and materials has caused some to postpone or cancel projects that are no longer commercially feasible and led observers to question what percentage of the two trillion USD in announced projects will actually be realized.

¶7. (SBU) Despite its top-notch reputation, Saudi Aramco faces the same challenges as its regional competitors. The "Petroleum Intelligence Weekly" reported in a March 10, 2008

article that due to the availability of too few contractors, Aramco is now relying on Italy's Snamprogetti to carry out multiple phases of approximately 31 billion USD in upstream projects. These projects include Khursaniyah, an oil and gas field which serves as an example of how major projects are falling behind schedule, and which left Saudi Aramco with a public relations embarrassment. Originally scheduled to begin production in December 2007, initiation of production at Khursaniyah was postponed until April 2008. Despite unidentified contractors and anonymous executives claiming in public articles that Aramco would not meet this new production timeline due to complications with the field's gas plant, Aramco executives insisted the company would reach the April goal. In February, Khalid al-Buainain, Senior Vice President for Refining, Marketing and International, stated that within two months, Khursaniyah would make available 500,000 barrels of oil per day. In an April 9 presentation to a London conference, Abdulaziz al-Judaimi, VP of new business development, announced that Khursaniyah would come on stream that same month. Not until a May 25 Bahrain conference did Khalid al-Falih, Executive Vice President of Operations, admit that delays in construction of a plant to process gas produced at the oilfield had prevented start-up. Calling it a "disappointment," al-Falih said it will be ready "in a few months." The Aramco maintenance of an official line, in spite of seemingly widespread knowledge that the project was behind schedule, only added to the concerns that had been fueled by the Total pull-out.

NEGOTIATED PRICE OF GAS TOO LOW?

¶8. (U) Per the upstream agreement signed between Aramco and the private companies participating in the Empty Quarter joint ventures, Saudi Arabia will pay an official rate of 0.75 USD per million British thermal unit of gas. In addition, a transportation fee of 0.15 USD per million Btu is paid by the private company for transportation. By comparison, prospective development costs in the Shah field, a challenging gas reservoir across the border in the UAE considered similar in nature to prospective findings in the Empty Quarter (high levels of hydrogen sulfide, high temperatures and high pressure), are between four and five USD per million Btu. At 0.75 USD per million Btu, there is very little chance of private firms profiting from the deal under any circumstances. When combined with rising costs and uncertain hydrocarbon findings, the incentive to continue exploration becomes even smaller.

¶9. (SBU) The Saudi Petroleum Ministry is following a policy of approving petrochemical projects that will ensure either production of new products or high value added. According to a May 25, 2008 article in the "Financial Times," a Gulf official was quoted as saying, "there is enough gas, but the problem is it's cheap and everybody wants to use it." EconOff conversations with a Ministry of Petroleum official echoed this sentiment, the official stating that gas reserves were sufficient for current projects but that that projects requiring a larger local workforce would be shown preference over typical capital intensive, low employment gas deals. Per the "Financial Times" article, however, there is a queue of projects in the petrochemical and aluminum industries that have been unable to secure the desired gas resources. This is further confirmed by post contacts in Jubail who claim that joint venture projects in that area have recently been provided with a higher percentage of oil feedstock than usual because of gas shortages.

PROBLEMS LOOMING GIVEN FUTURE SAUDI DEMAND

¶10. (U) With the low price of 0.75 USD fueling intense

development interest and public reports already suggesting that many projects are being refused due to limits in gas resources, future projections of gas demand create an alarming picture. Per an April 4, 2008 article in MEED, Saudi Arabia's current gas usage is approximately 5.5 billion cubic feet/day (cu/d). With Saudi Arabia's stated goal of becoming a leader in the petrochemicals industry, as well as the pressure that an industrializing economy and rising standard of living will create, Aramco predicts that the Kingdom's natural gas demand will reach 14.5 billion cu/d by ¶2030. Despite the fact that Saudi Arabia has the world's fourth-largest reserves of natural gas in the world at approximately 250 trillion cubic feet, the majority of this reserve is associated with oil-producing fields, meaning it is unavailable for development at rates faster than the fields' oil production. The need to find non-associated gas reserves cannot be overstated if Saudi Arabia desires to continue its rapid industrialization and efforts to diversify into industries beyond oil production.

¶11. (SBU) COMMENT: While the inability to find gas in the Empty Quarter has been a disappointment, there are signs of hope. Aramco plans to invest nine billion USD in the gas sector by 2012, with the aim of increasing reserves by more than twenty percent. The Karan gas field, thought to contain more than nine trillion cubic feet of gas, is scheduled to produce 1.5 billion cu/d of gas by 2011 (NOTE: Some analysts viewed the spin campaign and inability to meet Khursaniyah production goals as creating doubt regarding ambitious plans for Karan. END NOTE). And, while no commercial quantities of gas have been found in the Empty Quarter, there have been some discoveries. In early 2007, Luksar found an estimated 620 million barrels of oil equivalent in its drilling. The reserve is on the borderline between a gas and an oil finding, the determination of which will be key in deciding if Luksar is able to develop the discovery. EniRepSa has reported finding trace levels of gas, though nothing major. Despite the fact that dry wells discouraged Total, the gas findings made in Qatar and the UAE are part of the same general area that comprises the lands currently under exploration in Saudi Arabia. Though the low price currently being paid the private companies will likely have to be rethought, and the woes of an overburdened boom market will have to be negotiated in the short-term, it is still too early to declare that Saudi Arabia's hope for gas boom is a bust. END COMMENT.

(APPROVED: KINCANNON)
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